Initial Impact Assessment

Overall approach - assessing the impact

1. The Legal Services Act 2007 provides a common framework and set of objectives for all the legal services regulators and for the Legal Services Board (LSB), our oversight regulator. We must always have these in mind when we set the rules used to govern the conduct of the people and firms we regulate. These objectives are to:

    - protect and promote the public interest;
    - support the constitutional principle of the rule of law;
    - improve access to justice;
    - protect and promote the interests of consumers;
    - promote competition in the provision of services;
    - encourage an independent, strong, diverse and effective legal profession; and
    - increase public understanding of the citizens' legal rights and duties.

2. This statement considers the potential impacts on firms and consumers resulting from the changes we propose to the Accounts Rules and we have aimed to assess these changes with the regulatory objectives, the better regulation principles and our wider equalities duty in mind. Where we have identified possible adverse impacts arising from our proposals we explain the steps we will take to mitigate these. It may be that some impacts cannot be assessed due to a lack of information or because that an impact can only be realised once a policy has been implemented. We will therefore continue to review our data in respect of the number of reports received relating to a breach of the Accounts Rules and consider how firms can be supported through guidance and case studies that form part of the online toolkit.

3. As noted above, we have a regulatory objective to encourage an independent, strong, diverse and effective legal profession and also have to comply with our public sector equalities duty. We have not identified any data as part of this review which suggests any particular diversity impacts. We will therefore be engaging with firms and representative groups over the course of the consultation period to determine whether there are any specific impacts we need to consider and address.

4. The framework and rationale of our review of the Rules is designed to achieve the following:

- remove unnecessary barriers and restrictions and enable increased competition, innovation and growth to better serve the consumers of legal services;

- reduce unnecessary regulatory burdens and cost on regulated firms ensure that regulation is properly targeted and proportionate for all solicitors and regulated businesses, particularly small firms; and,

- maintaining an appropriate level of consumer protection.

5. Key changes that are being consulted are to:

- Simplify the Accounts Rules by focusing on key principles and requirements for keeping client money safe, including:

    - keeping client money separate from firm money

    - ensuring client money is returned promptly at the end of a matter

    - using client money only for its intended purpose

    - proportionate requirements for firms to obtain an annual accountant's report

  This will put the focus on what is important and allow firms greater flexibility to manage their business and help consumers understand how their money will be protected. The Accounts Rules will also be simpler and easier to understand - increasing compliance and reducing compliance costs. A draft of the Accounts Rules is provided at Annex 1.1 of the consultation paper. As with the Codes of Conduct, the Accounts Rules will be supported by clear guidance, case studies and toolkits to aid compliance.

- Change the definition of client money to allow money paid for all fees and disbursements for which the solicitor is liable (for example counsel fees) to be treated as the firm's money. Money held for payments for which the client is liable, such as stamp duty land tax, will continue to be treated as client money and therefore required to be held in client account. The impact of the proposed change in definition is expected to remove the need to have a client account for some firms and therefore reduce the associated compliance costs. The changes may also reduce the number of firms required to obtain an accountant's report through the subsequent reduction in the client account balance.

- **Provide an alternative to the holding of client money:** through the introduction of clear and consistent safeguards around the use of third party managed accounts (TPMA) as a mechanism for managing payments and transactions.

This is our initial impact assessment which considers the impact of each key change on both firms and consumers. We will develop our final impact assessment as we consider responses to the consultation and decide next steps.

Key change 1 - simplification of the Accounts Rules

Impact on firms

6. The current Accounts Rules are prescriptive and complex. Rather than focusing on the key risks to client money they seek to mitigate those risks by prescribing how firms should run their accounting systems. As the Accounts Rules have developed over many years, much of this prescription has developed to address specific issues and is based upon traditional models of practice. This can make it difficult for new entrants to understand and comply with the Accounts Rules. Further, many firms find themselves in technical breach of the rules in circumstances where there are no real risks to client money. As highlighted in our earlier consultation[1] on reporting accountant's requirements, of the approximately 9000 firms that hold client money, in the period June 2012 to December 2013, over 50% received a qualified accountant's report but only 179 were consideration for further regulatory action[2].

7. We are proposing to remove the unnecessary prescription from the Rules, and reduce both the length and complexity. The draft Accounts Rules currently stand at 6 pages – down from 32 pages. A simpler set of Accounts Rules is not only easier to understand, particularly for new entrants, but more accessible for a range of different business models. This has the potential to remove a barrier for new entrants who at the moment may be so intimidated by the detail, length and complexity of the current Rules they are put off from SRA regulation altogether.

8. The proposed Accounts Rules provide greater flexibility to all providers. For example we have removed the prescriptive time limits for which money should be moved from one account to another. We often hear from firms that the current prescriptive time frames don't work. This is for different reasons - for firms in rural areas the current time limits may not be realistic - and for larger firms they may be far slower than what their clients expect.

9. In the longer term we envisage the simplicity of the Accounts Rules could reduce compliance costs for all providers - with less time spent on setting up specific systems and processes because they are required by our Rules rather than because they fit with the rest of the business and clients. For example - we have retained a requirement to ensure reconciliations are completed at least every 5 weeks. This is a minimum requirement which is an important mitigation to the risks to client money. But for many firms, particularly larger firms, reconciliations will be done more frequently (even daily) because that is what their business and clients expect. We envisage

[1] http://www.sra.org.uk/sra/consultations/reporting-accountant.page

[2] http://www.sra.org.uk/Solicitors_Regulation_Authority/sra/how-we-work/board/public_meetings/archive/SEP14_7_-_Reporting_Accountant_Requirements.pdf

that the changes may also reduce the level of interaction that some firms have with the SRA in relation to technical breaches. This is something we will need to consider as we develop the suite of guidance and case studies to support the Accounts Rules.

10. We have been engaging with firms as we develop our proposals and are keen to gather information as to the impacts of the changes on for example, type of firms by way of size or ethnic make up of firm personnel to inform our final impact assessment.

11. The proposed changes also impact on accountants and other personnel for example, Legal Cashiers - both in the role they may play within firms and in the role of reporting accountant. We have engaged closely with accountants throughout earlier phases of this review and have continued to do so as part of the third and final phase. The proposals to simplify the Accounts Rules will bring them into line with our expectations for reporting accountants to assess the real risks to client money (as opposed to identifying technical breaches) - introduced in Phase 2 of our review. We envisage this will make the role of the reporting accountant easier in the future.

Impact on consumers

12. As is the case under the current Accounts Rules, a firm's primary objective will be to ensure that client money and assets will be protected, and the firm has in place systems and procedures which ensure compliance with the rules so that client money is used only for that client's matter. This is reflected in both the Accounts Rules and the Code of Conduct for Solicitors and Code of Conduct for Firms. These obligations bite regardless of the size and makeup of the firm or other characteristics. The effective controls and procedures a firm has in place *should* act as an assurance for consumers and give them confidence that their funds will be kept safe.

13. Simpler rules will make it easier for consumers to understand the key principles for regulation in this area, in other words that client money and assets must be safeguarded. They also focus firms on addressing the real risks to client money.

14. We consider that the proposed Accounts Rules provide an important protection to consumers by safeguarding their money. We do not consider that our proposals reduce or dilute in any way the obligation on firms, their managers or employees to keep money safe. This helps demonstrate that we are acting in accordance with the objective to protect and promote the interests of consumers and support the constitutional principle of the rule of law.

15. The main consumer impacts relate to the key policy changes regarding the definition of client money and our proposal that firms may chose to offer the alternative of client money being held in a Third Party Managed Account (TPMA) - set out in the following sections.

Key change 2 - redefining client money

Impact on firms

16. As part of the Practising Certificate Renewal Exercise (PCRE) exercise for 2015/16, 7528 authorised firms declared that they held client money. These firms are all required to comply with the current Accounts Rules, and the associated costs of running a client account. While there are some benefits to firms in terms of interest and better banking terms the costs of running a client account are significant. Firms that hold client money are also required to make a contribution of over £500[3] to our compensation fund which provides a discretionary safety net in the event of dishonesty or a failure to account. The exact costs of complying with the Accounts Rules are difficult to quantify, however we know that approximately 6000 firms are required to obtain an Accountant's Report. We understand from practitioners that a small firm may pay around £800 for each annual accountant's report, but that larger firms may pay several thousand pounds[4]. As a proportionate regulator we need to consider whether these obligations can be justified. The changes we are proposing to the definition of client money will help ensure that the protections provided by the Accounts Rules apply only where needed.

17. If we proceed with the change in the definition of client money, it may be the case that some of these firms may no longer be holding client money – as more narrowly defined – and would no longer be required to have maintain a client account and therefore comply with the associated Accounts Rules. It is therefore envisaged that a reclassification of this type of money may lift a proportion of firms out of the cost and burden of regulation that come with the client account altogether. We do not have specific data which sets out the number of firms that currently hold client money in the form of payment on account of costs or professional disbursements so it is difficult to determine precisely how many firms may be affected in this way.

18. By redefining client money, it may be that there will be a change in the average and total client balances held by firms which is likely then to take more firms out of the need to obtain an accountant's report if the balance meets our exemption criteria[5].

19. In terms of professional disbursements falling outside the proposed definition of client money, it may be that some firms will have to review how they engage with professional experts instructed on behalf of a client. The key point here is that the firm remains liable to the expert and not the client. For this reason these relationships can be differentiated from the relationship that

[3] Under the SRA Fee Policy 2015/16, firms that hold client money are required to contribute £548 to the compensation fund. A flat fee of £32 is also payable by every individual solicitor/REL/RFL http://www.sra.org.uk/mysra/fees/fee-policy-2015-2016.page

[4] http://www.sra.org.uk/sra/consultations/reporting-accountant.page

[5] Phase one changes came into effect in October 2014 and introduced an exemption for firms where 100% of work is funded by legal aid from the need to obtain that report . We also removed the requirement for firms to submit to us reports where these found no failure to comply with the Rules. Phase two was implemented in November 2015, and encouraged reporting accountants to apply an outcomes-based approach to assessing compliance, with a greater focus on risks to client money. We also extended the exemption from the obligation to obtain an accountant's report to firms that have an average client account balance of no more than £10,000 and a maximum balance of no more than £250,000 over the accounting period

a solicitor shares with their client and therefore, costs/monies due to these individuals do not need to be treated in the same way as money held on behalf of a client i.e. being ring fenced in client account . Many professionals will have engaged with firms previously when providing their services and will be in a better position to negotiate their terms of business. These terms, in our view, should not be determined by us and reflected in the Accounts Rules. The remaining indirect risk to clients through for example, payments to experts not being made promptly by the firm (to retain the funds in their business account to minimise an overdraft) is covered by broader obligations in the Codes of Conduct to act in the client's best interests and ensure that money and assets entrusted to the firm are properly safeguarded.

Impacts on firm systems and training

20. The legal services compliance market already provides online resource and bespoke IT packages to help firms and individuals comply with the Accounts Rules. Providers say that the aim of these facilities is to help firms:

- Update their systems and control procedures to improve compliance of the Accounts Rules; and,
- Adopt best practice with respect to the Accounts Rules.

21. For those firms that continue to hold client money, the change in definition is likely to impact on systems and processes in the short term as they make changes to their accounting systems to ensure only client money (as redefined) is continued to be paid into client account. However, in the longer term we anticipate this will provide firms with greater flexibility for managing their accounting systems and for some the opportunity to avoid the costs of managing a client account.

22. Simplifying the definition of client money should reduce costs or result in no material change in costs over the long term. It is envisaged that current systems will adapt as client money will still need to identified and held in accordance with the proposed Accounts Rules.

23. We are keen to engage with software, compliance and training suppliers in particular as to whether there is any information to help inform our final impact assessment.

Impact on consumers and consumer protection

24. Consumer confidence in the legal services market is underpinned by an expectation that client money will be safeguarded. This protection is primarily delivered through an obligation to comply with the Accounts Rules and thereby protecting and promoting the interests of consumers. The change in definition is intended to target regulatory protections on the categories of client money where the risks are highest. We consider the proposed approach presents a better balance between regulatory burden and consumer protection.

25. We have explained in the consultation paper that we do not consider that there is a case for removing certain types of disbursements and costs, such as stamp duty land tax and Land Registry fees, from the definition of client

money and the protections provided by the Accounts Rules. These liabilities can be significant and removing them from the definition of client money (and associated consumer protections) presents a significant risk to the consumer. This is supported by data from the Compensation Fund which shows the Fund paid out over £3m for these types of disbursements over the past two years. Our proposals to redefine client money will not change the protections[6] afforded to clients with regards to transactional monies and costs for which they (the client) is personally liable.

26. As we have explained in the consultation paper, our position on fees and proposal to treat fees paid in advance as the firm's own money relates in part to the range of consumer protections available to consumers outside of our regulation.

27. Consumer protection in legislation has improved substantially since the Accounts Rules were drafted. The Consumer Rights Act[7] provides consumers with statutory rights; to services to be performed with reasonable care and skill, to pay a reasonable price for a service and for services to be performed in a reasonable time. The Act also provides remedies including; claiming damages, seeking repeat performance and the right to a price reduction. The provisions relating to the supply of services consolidate various pieces of existing legislation and regulation and will apply to firms authorised by the SRA.

28. A change of definition of client money would not affect a consumer's ability to complain to the Legal Ombudsman (LeO) and to seek compensation, for instance if the work is not completed. The maximum level of compensation that can be paid out is £50,000, however, LeO also have the power to order a refund or reduction in legal fees up to a maximum of 100%.

29. Under Section 75 of the Consumer Credit Act, consumers that have paid by credit card can make a claim against their credit provider for; a breach of contract by the supplier of services, a lack of provision in part of in full of the services, or for not providing the services as specified; so long as the services were bought for between £100 and £30,000. These provisions apply to circumstances where a company becomes insolvent, leading to a non-receipt of the services. Via the Financial Ombudsman the protection of Section 75 can lead to full repayment and can also include additional statutory interest payments and costs due to inconvenience caused to the claimant. However, there are some transactions where Section 75 may not apply - these include where the payment has been made through an online payment service and where a third party is involved.

30. Some of the potential risks to consumers of the proposed change in definition are set out in the table at Annex 1.4 of the consultation paper. These examples also provide our assessment of how the consumer protections set out above might apply in practice. We therefore consider that on balance the risk of consumer detriment is more than mitigated by the potential redress

[6] Section 85 Solicitors Act 1974 also provides an additional protection for client money held in a firm's client account by ensuring that the bank/building society cannot take money held in a client account to discharge any liability of the firm to the bank/building society.
[7] http://www.legislation.gov.uk/ukpga/2015/15/contents/enacted

mechanisms available, albeit we accept that these may take considerable time and determination for clients to pursue.

31. We acknowledge that the Accounts Rules cannot prevent dishonesty on the part of a solicitor (or his/her employee) or a failure in firm systems and controls that result in client monies being stolen or not accounted for. And the risk of dishonesty may be increased by the proposed change in definition (as firms will be able to request advance payment for fees and disbursements and not have to pay the money into client account).

32. In the case of intervention, our power to intervene into a firm and take control of all funds held by the firm remains unaffected irrespective of whether or not it is client money. The potential impact of the change in definition is that monies paid in advance for fees or other related payments for work that has not yet been done, will not be protected in the client account. In the majority of instances, the firm's own account is overdrawn at the point of intervention and this money is therefore lost. In those circumstances the client, if eligible, would be able to claim on the Compensation Fund (as it is not currently restricted to "client money").

33. As noted above, the potential detriment to consumers is therefore likely to be the ease of access to redress in the event that something goes wrong. However we need to look at this risk in the context of the firms we regulate. Data from 2014/15 shows that we carried out 93 interventions - less than 1% of all firms we regulate. This supports our view that it would disproportionate to design policy based on the risk that something goes wrong. Further, the data on interventions also reveals that the current detailed rules do not effectively mitigate against risks to client money. Close to half of interventions (46 of the 93) included breaches of the Accounts Rules as the grounds for the intervention. We have received £32m as result of these interventions and paid out £18.5m from the compensation fund to clients as a result of them .

34. It is expected that the impact on clients in terms of how transactional money is managed will not change, however, firms will need to ensure that clients are clearly informed about how other costs (such as payments made to pay Counsel) will be dealt with. Clients need to be in a position to make informed choices and how a firm engages with third parties on their behalf will inform those decisions.

35. We have taken enforcement action in a number of cases where firms have in breach of the current rules deliberately held payments received for unpaid professional disbursements in the business accounts than the client account or used them for other purposes. These cases include several cases we have brought before the Solicitors Disciplinary Tribunal (SDT). Most cases centre around firms, in financial difficulty, failing to use money that the firm has received from clients to pay the professionals involved. Instead and contrary to the Rules, the firms keep those funds in office account, sometimes for several years, to reduce the firm’s overdraft to an acceptable level. We cannot find evidence of immediate impact upon clients in these circumstances (as opposed to the professional who remains unpaid) but there is risk of delay in progression of their matter. Removing unpaid professional disbursements from the definition of client money therefore constitutes a significant change from our current approach and we will consider the impact

on consumers by emphasising the duty of all solicitors to act in accordance with the Principles and standards in the Code of Conduct for Solicitors.

36. In cases where a firm or sole practitioner becomes insolvent (and the SRA has not intervened and taken control of both client and practice money) the administrator or trustee in bankruptcy has no jurisdiction over client account and there should be no question of the administrator/trustee in bankruptcy being able to use it for creditors. There is a potential risk that the administrator/trustee in bankruptcy may try to exert a claim on monies that were paid on account of fees and disbursements (for work not yet done) that would now, having regard to the proposed definition of client money be held in the firm's business account. In these circumstances, the client may be able to apply to the Compensation Fund (depending on eligibility to make a claim) but the original money which was paid to the firm may have gone to pay the administrator/trustee in bankruptcy first and then the creditors and so the Compensation Fund will be in effect subsidising those two categories.

Key change 3 - permitting authorised firms to use alternatives to holding client money such as third party managed accounts (TPMA)

37. We are proposing rules that will allow solicitors in SRA authorised firms to use Third Party Managed Accounts (TPMA) as an alternative to holding client money.

38. Those Rules would permit entities to use a TPMA where the firm could demonstrate:

    a) the TPMA is either an authorised payment institution and a result has mandatory safeguarding arrangements , or is a small payment institution which has adopted voluntary safeguarding arrangements; and,
    b) they can demonstrate that the firm has suitable arrangements for the implementation, use and monitoring of TPMAs. For example that use of TPMAs is suitable for the types of transactions, appropriate information is provided to clients and appropriate internal controls are in place.

Impact on firms

39. The success of the TPMA market will depend on TPMA providers offering a service in a way that is commercially attractive to firms (and their clients) as an alternative to holding a client account, and which offers sufficient speed and security of transactions. It is envisaged that small firms and new entrants are most likely to take advantage of TPMA as this removes the cost of operating a client account and shifts the associated regulatory obligations on to the TPMA provider to ensure that money is kept safe. Large and medium sized firms may also consider using TPMA where they only occasionally hold client money.

40. By allowing firms to hold client money in a TPMA it is envisaged that this will help achieve the regulatory objective that our arrangements promote

competition in the provision of legal services. Firms will be able deploy resource to build robust business models and allow clients the choice of how their money should be held. Historically, small firms and sole practitioners have been associated with the risks of holding client money - holding money in a TPMA may over time remove that association and allow small firms to compete in a market that allows for innovation and flexibility in approach. Several insurers have indicated that they welcome the use of TPMA as a mechanism for reducing their risk. We are keen to hear from insurers as to whether firms that hold client money in a TPMA will see a reduction in insurance premiums.

Impact on consumers

41. A consistent risk to consumers is the misuse of client money. The availability of TPMAs may offer improved security and protection for consumers. The very nature of a TPMA, by definition, is that the client is a third party to the account and therefore has the ability to approve transactions or to withdraw their money when needed. It is our working assumption that the compensation fund would not apply in relation to TPMAs.

42. We are seeking to mitigate any risks to the consumer by requiring firms to use TPMA which are either an authorised payment institution (and as a result has mandatory safeguarding arrangements), or is a small payment institution which has adopted voluntary safeguarding arrangements (set out in more detail in the main consultation document). We will also introduce requirements to ensure sufficient information is provided to the client, especially prior to entering into a TPMA arrangement, and to ensure a clear understanding of the terms of the contract including their right to terminate.